By Mary H. Rose[1]

Reining in the California AG in the Sale of a Nonprofit Hospital

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California law, by statute and regulation, gives the California attorney general extensive authority over the sale of nonprofit health facilities.[2] In addition to giving the attorney general discretionary authority to consent or not consent to the sale, the attorney general can impose numerous conditions by giving conditional consent to the sale, such as continuing charity care obligations, continuing community benefit obligations, maintenance of types and levels of health care services, and participation in the Medi-Cal program.

These state law requirements are significant in a bankruptcy sale because the amendments to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) require that the sale or transfer of assets of a nonprofit debtor be made only in accordance with applicable nonbankruptcy law.[3] What BAPCPA's drafters did not contemplate, however, was potential overreaching by a state attorney general in exercising purported rights under applicable nonbankruptcy law.

In *In re Gardens Regional Hospital and Medical Center Inc.*,[4] Hon. **Ernest M. Robles** reined in overreaching by the California attorney general in two important respects. First, the court determined that because the claimed authority of the attorney general was an "interest in property," the debtor's assets could be sold free and clear of that interest under § 363(b) and (f)(1) of the Bankruptcy Code. Second, the court found that under the applicable California statute, the attorney general had no authority over the sale of assets of a nonprofit hospital that had closed and was no longer operating.

Attorney General Conditions on First Proposed Sale

Gardens Regional Hospital and Medical Center Inc., a California nonprofit public benefit corporation, owned and operated a 137-bed general acute care hospital in Hawaiian Gardens (Los Angeles County), Calif. After more than five years of operating losses under a series of management companies, the company filed a voluntary chapter 11 petition on June 6, 2016. The debtor continued to operate the hospital as a debtor in possession (DIP) and promptly noticed an auction for the sale of its assets. The auction attracted four bidders and lasted four days. On July 28, 2016, the bankruptcy court approved a sale of substantially all of the debtor's assets to Strategic Global Management Inc., a for-profit entity, for approximately $19.5 million. Strategic thereafter assigned its rights to KPC Global Management LLC, a for-profit affiliate of Strategic.

The order approving the sale to Strategic expressly did not determine whether the attorney general had the authority to review the sale. Nevertheless, the debtor complied with the state law statutory review procedures and submitted more than 5,000 pages of information to the attorney general, obtained and paid for a health care impact report prepared by an independent third party, and attended a public meeting conducted by the attorney general for the purpose of receiving community comments regarding the proposed sale.

On Nov. 18, 2016, the attorney general conditionally consented to the sale to KPC. The most onerous of the attorney general's conditions required KPC to (1) provide charity care of $2.25 million per year for six years, (2) provide community-benefit services of $859,000 per year for six years, and (3) participate in the Hospital Quality Assurance Fee Program by assuming all of the debtor's known and unknown monetary obligations under the Medi-Cal program, a liability of at least $2.4 million.[5] Collectively, these conditions added more than *$21 million* to the cost of the acquisition by KPC.

The debtor twice asked the attorney general to modify these conditions, and the attorney general refused in letters dated Dec. 16, 2016, and Jan. 11, 2017.[6] As a result, both KPC and the back-up bid-

1 The author represented Promise Hospital of East Los Angeles as the stalking-horse bidder and initial DIP lender, and then as the proposed private sale buyer, in the *Gardens* chapter 11 case.

2 Cal. Corp. Code § 5914, *et seq.*; 11 Cal. Code Regs., tit. 11, § 999.5.

3 *See* §§ 363(d)(1) (use, sale or lease of property in case of debtor that is corporation or trust that is not moneyed business, commercial corporation or trust), 541(f) (transfer of property held by debtor that is corporation described in § 501(c)(3) of the Internal Revenue Code of 1986 and exempt from tax under § 501(a) of such Code to any entity that is not such corporation), and 1129(a)(16) (transfer of property under plan by corporation that is not moneyed, business or commercial corporation or trust); BAPCPA § 1221(e) ("Nothing in this section shall be construed to require the court in which a case under chapter 11 … is pending to remand or refer any proceeding, issue or controversy to any other court or to require the approval of any other court for the transfer of property.").

4 567 B.R. 820 (Bankr. C.D. Cal. 2017).

5 For a discussion regarding the impropriety of the attorney general's condition that Strategic assume the debtor's Medi-Cal liabilities, *see* Samuel R. Maizel, Khoi Ta and Matt Weiss, "Extent of State's Power at Issue in Nonprofit Hospital's Asset Sale," *J. Corp. Renewal* (March 2017).

6 Inexplicably, in the letter dated Jan. 11, 2017, the Attorney General's Office stated that it had no authority to modify the sale conditions ("This office does not have authority to retract its approval of the sale, or the conditions that were imposed in the transaction on November 18, 2016.").

continued on page 56

from page 16

der informed the debtor that they were no longer willing to proceed with the sale.

By this time, the debtor was nearly out of cash. Its operating losses during the chapter 11 case had exhausted the $3.13 million in DIP financing provided by Strategic, and its lack of unencumbered assets made it impossible to obtain additional financing. Under the circumstances, the bankruptcy court granted the debtor's emergency motion to close the hospital by order entered Jan. 20, 2017. The last remaining patient was transferred out of the hospital on Feb. 2, 2017, and the debtor placed its hospital license in suspense.

No Attorney General Rights After Hospital Closed

Promise Hospital of East Los Angeles LP, the original stalking-horse bidder in the July 2016 auction, was willing to buy assets of the closed hospital, but only at a significantly lower price, and only if it would not be subject to the kinds of onerous monetary conditions that the attorney general had imposed on KPC. On April 12, 2017, the debtor filed a motion to approve a private sale of certain of the debtor's assets to Promise Hospital free and clear of any regulatory review, claims or interests asserted by the attorney general. The purchase price offered by Promise Hospital was approximately $4.5 million, although a last-minute bidder who appeared at the sale hearing, American Specialty Management Group Inc., increased the purchase price to approximately $6.7 million. Despite vigorous opposition by the attorney general, the bankruptcy court approved the sale to American Specialty free and clear of the attorney general's claimed authority under applicable nonbankruptcy law.

Attorney General Authority as an "Interest in Property"

The bankruptcy court expressly approved the sale of the debtor's assets free and clear of the attorney general's claim that he could impose conditions on the sale terms, including monetary conditions. The basis for approval was § 363(f)(1), which provides that a sale of estate property under § 363(b) may be "free and clear of any interest in such property of an entity other than the estate, only if ... applicable nonbankruptcy law permits sale of such property free and clear of such interest."

The bankruptcy court concluded that the phrase "interest in property" under § 363(f)(1) includes monetary obligations arising from ownership of the property, even when those obligations are imposed by statute. Thus, for example, a bankruptcy sale may cut off a debtor's experience rating under unemployment insurance statutes,[7] or a debtor's monetary obligations to a retiree benefits plan under the Coal Industry Retiree Health Benefit Act of 1992.[8] Here, because the attorney general's state law regulatory authority arose out of the original charitable character of the assets, the assets could be sold free and clear of the attorney general's interests.

> **[U]nder applicable nonbankruptcy law, the debtor was not required to obtain the attorney general's consent to sell the assets of its closed nonprofit hospital.**

The California Statute

Section 5914(a) of the California Corporations Code provides, in pertinent part:

> Any nonprofit corporation that … operates or controls a health facility, as defined in Section 1250 of the Health and Safety Code … shall be required to provide written notice to, and to obtain the written consent of, the Attorney General prior to entering into any agreement or transaction to … [s]ell … its assets to a for-profit corporation or entity … when a material amount of the assets of the nonprofit corporation are involved in the agreement or transaction.

Section 1250 of the California Health and Safety Code defines a "health facility" as

> a facility, place, or building that is organized, maintained, and operated for the diagnosis, care, prevention, and treatment of human illness, physical or mental, including convalescence and rehabilitation and including care during and after pregnancy, or for any one or more of these purposes, for one or more persons, to which the persons are admitted for a 24-hour stay or longer.

The question of whether a closed hospital qualifies as a "health facility" for purposes of § 5914(a) was a matter of first impression that had not been decided by a California court. Applying principles of statutory construction under California law, the bankruptcy court found that the statutory definition of a "health facility" was written in the present tense. A facility can only qualify as a "health facility" if it is currently open and admitting patients. The fact that the facility formerly operated as a health facility — or that it might again in the future operate as a health facility if its license were reinstated — does not change the fact that a facility that is not currently open and admitting patients is not a "health facility" for purposes of § 5914(a).

The attorney general argued that permitting the sale to proceed without his consent would subvert § 5914's purpose of protecting public health, safety and welfare by encouraging other facilities to temporarily cease operations in order to circumvent the attorney general's review of a sale of those facilities' assets. The bankruptcy court disagreed, noting that the intent of § 5914, as reflected in its legislative history, was

7 *Massachusetts Dep't of Unemployment Assistance v. OPK Biotech LLC (In re PBBC Inc.),* 484 B.R. 860 (B.A.P. 1st Cir. 2013).

8 *United Mine Workers of Am. Combined Benefit Fund v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.),* 99 F.3d 573 (4th Cir. 1996).

to ensure that the public was not deprived of the benefits of charitable health facilities as a result of the transfer of those facilities' assets to for-profit entities.[9]

In this case, however, the debtor's hospital was not operating at the time of the sale and thus was providing no health care services to uninsured low-income families. Moreover, the debtor's assets were fully encumbered by the claims of secured creditors, leaving no remaining equity that could be devoted to charitable purposes. As stated by the bankruptcy court, "With the charitable assets having been exhausted, nothing remains to be protected by the Attorney General."

The bankruptcy court also rejected the attorney general's argument that nonprofit health facilities will deliberately close in order to evade attorney general review of a sale. The sale price for the debtor's hospital plunged by approximately $8 million (after adjusting for differences in the assets being sold)[10] as a result of the hospital's closure. As stated by the bankruptcy court, "It strains credulity that other nonprofit hospitals would voluntarily close to escape the Attorney General's review of a sale, when closure results in such significant value destruction." Further, the debtor in this case closed the hospital only because the attorney general's "onerous and unrealistic financial conditions" on the prior proposed sale made it impossible to sell the hospital as an operating facility. Thus, the bankruptcy court determined that under applicable nonbankruptcy law, the debtor was not required to obtain the attorney general's consent to sell the assets of its closed nonprofit hospital.

Other Nonprofit Asset Sales

Although not discussed in the *Gardens* opinion, the decision was consistent with the decisions of other bankruptcy courts that have considered the application of nonbankruptcy law to sales of assets of nonprofit debtors. In *In re HHH Choices Health Plan LLC*,[11] the bankruptcy court considered a state law requirement for transfer of the assets of a nonprofit senior housing facility under New York law, which required approval of the transfer by the New York state court. The bankruptcy court held that although § 363(d)(1) requires application of the substantive aspects of state law, the bankruptcy court had exclusive jurisdiction over the estate and its assets, and any determination of state law that would be made by a state court in the absence of a bankruptcy case should be made by the bankruptcy court in a bankruptcy case.[12]

In *In re Machne Menachem Inc.*,[13] a bankruptcy court similarly decided the substantive aspects of state nonprofit transfer law. In that case, the bankruptcy court considered § 1129(a)(16) of the Bankruptcy Code, which requires compliance with applicable nonbankruptcy law for transfers of nonprofit assets under a chapter 11 plan. Specifically, the bankruptcy court determined (in the absence of any New York judicial precedent) that while New York law required approval by the New York state court for a voluntary sale or other transfer of assets of a nonprofit corporation, no approval was required for an involuntary transfer. Thus, a sale of assets of a nonprofit religious summer camp, under a chapter 11 plan proposed by a creditor, was an involuntary transfer that did not require state court approval.

The Attorney General's Appeal

The attorney general has appealed the *Gardens* decision to the district court.[14] Both the bankruptcy and district courts denied the attorney general's motion for a stay pending appeal, and because the sale has closed, the appeal may be moot under § 363(m) of the Bankruptcy Code. The attorney general is nevertheless seeking to prosecute the appeal on the grounds that "the issues are capable of repetition, yet evading review."[15] It is not yet known whether the appeal will survive a motion to dismiss on the grounds of mootness. It also remains to be seen in a future case whether the assets of an operating nonprofit hospital in California can be sold free and clear of the attorney general's rights of review and consent under nonbankruptcy law. abi

9 1996 Cal. Stats. ch. 1105 (AB 3101).
10 The assets to be sold to KPC included the debtor's accounts receivable, while the assets being sold to American Specialty did not.
11 554 B.R. 697 (Bankr. S.D.N.Y. 2016).
12 *Id.* at 700-01.
13 371 B.R. 63 (Bankr. M.D. Pa. 2006).
14 *Becerra v. Am. Specialty Mgmt. Grp. (In re Gardens Reg'l Hosp. & Med. Ctr. Inc.)*, Case No. 2:17-cv-3708-JLS (C.D. Cal.).
15 *Id.*, Docket No. 31.